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TAX TREATMENT OF DIVIDENDS RECEIVED BY CERTAIN CONTROLLED FOREIGN CORPORATIONS

SEPTEMBER 16, 1982.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 3581]

The Committee on Ways and Means, to whom was referred the bill (H.R. 3581) to amend the Internal Revenue Code of 1954 to exclude certain foreign commodity income from treatment as foreign personal holding company income, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are as follows:

Strike out all after the enacting clause and insert in lieu thereof the following:

That (a) for purposes of section 954(a)(1) of the Internal Revenue Code of 1954, foreign base company income does not include any dividend received by a controlled foreign corporation from a qualified foreign subsidiary if—

(1) the dividend is out of earnings and profits of the qualified foreign subsidiary (for a taxable year beginning after 1982) and is attributable to the active conduct of the business of buying, selling, and distributing coffee,

(2) neither the country of incorporation of the controlled foreign corporation nor the country where the principal office of such corporation is located imposes any tax with respect to the receipt of such dividend,

(3) the controlled foreign corporation was incorporated before 1962 and its principal activity is carrying on a trade or business which it carried on for many years before 1962 and which it has continuously carried on since 1962 and through the date of the distribution, and

(4) the taxpayer acquired control of the controlled foreign corporation in 1978, but such control has been limited at all times after 1978 and before the date of the distribution by the fact that more than ½ of the stock which it holds in the controlled foreign corporation is held as beneficiary of a trust with respect to which the taxpayer's authority to appoint trustees is shared with the management of the controlled foreign corporation.

For purposes of paragraph (1), dividends out of the earnings and profits for any taxable year shall be treated as attributable to the active conduct of the business of buying, selling, and distributing coffee to the extent that such dividends do not exceed the portion of the earnings and profits attributable to such business for such year.

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(b)(1) For purposes of this section, the term "qualified foreign subsidiary" means any foreign corporation—

(A) substantially all the stock of which is owned by the controlled foreign corporation, and

(B) to which an election under this subsection applies.

(2) election under this subsection may be made only by the taxpayer described in subsection (a)(4) and only with respect to 1 foreign corporation. Such an election shall be made not later than the 60th day after the date of the enactment of this Act. Such an election, once made, shall be irrevocable.

(c) The provisions of this section shall apply to taxable years of foreign corporations beginning after December 31, 1982, and to taxable years of United States shareholders within which or with which such taxable years of such foreign corporations end.

Amend the title so as to read:

A bill to provide that certain dividends received by a controlled foreign corporation will not be treated as foreign base company income.

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I. SUMMARY

Under present law, dividends received by a foreign corporation which is controlled by U.S. shareholders are considered foreign personal holding company income and as such may be taxable to the U.S. shareholders.

Under the bill, dividends received by a controlled foreign corporation out of earnings and profits accumulated by one foreign subsidiary (that it elects) in taxable years beginning after December 31, 1982 and attributable to the active conduct of the business of buying, selling, and distributing coffee will not be considered foreign personal holding company income if the country of its incorporation and the country where its principal office is located do not tax the dividend, if the controlled foreign corporation was incorporated before 1962, if its main activity is a continuation of activity begun many years before 1962, if the controlled foreign corporation was acquired in 1978, and if more than half of the U.S. parent's control has been limited at all times after 1978 and before the date of distribution by indirect ownership through a voting trust.

II. EXPLANATION OF THE BILL

Present Law

In the Revenue Act of 1962, Congress enacted legislation intended to tax certain tax haven and other tax avoidance income of foreign corporations established by U.S. taxpayers. Before the 1962 legislation a U.S. taxpayer could accumulate income outside the United States or engage in the tax avoidance transactions through a foreign corporation and not pay U.S. tax on that income until the corporation paid a dividend to the U.S. shareholder.

Under the 1962 legislation (secs. 951 through 964), U.S. shareholders of a controlled foreign corporation are subject to current taxation on their proportionate share of certain categories of undistributed profits from tax haven activities and certain other activites of the controlled foreign corporation. Foreign taxes paid on that income can be credited against any U.S. tax imposed. This income ("subpart F income") includes certain sales income where the property is sold to or purchased from a related person. It also includes foreign personal holding company income. Dividends and other passive income are considered foreign personal holding company income. Generally, a dividend received by a controlled foreign corporation is treated as subpart F income taxable to the U.S. shareholders even if the paying corporation's income is not subpart F income.

Reasons for Change

The committee is informed that in 1978, Consolidated Foods Corporation, a U.S. corporation, purchased 65 percent of the stock of Douwe

Egberts Koninklijke Tabaksfabriek—Koffiebranderijen—Theehandel B.V. ("Douwe Egberts"), a Dutch corporation. Forty percent of Consolidated Foods' interest in Douwe Egberts (26 percent of the stock of the company) is held directly by Consolidated Foods, while 60 percent of Consolidated Foods' interest (39 percent of the company's stock) is held by a voting trust that benefits Consolidated Foods. The trustees of that voting trust are three independent Dutch citizens appointed by Consolidated Foods and Douwe Egberts' management jointly.

Douwe Egberts is engaged in the production and distribution of coffee, tea, and tobacco products. Incorporated in Holland in 1919, it has been in business since 1753.

Douwe Egberts has several active non-Dutch subsidiaries with accumulated earnings and profits. The Dutch taxing authorities have been concerned that Douwe Egberts, by financing its activities through borrowing rather than through dividends from those non-Dutch subsidiaries, would obtain unwarranted interest deductions. Therefore, Douwe Egberts has been subject to some pressure from the Dutch taxing authorities to cause its subsidiaries to declare dividends, even though Holland would impose no tax on dividends remitted by those subsidiaries.

The Internal Revenue Service has ruled that dividends remitted to Douwe Egberts by its non-Dutch subsidiaries would be foreign personal holding company income of the Dutch company, a pro rata share of which would be taxable to the U.S. parent, Consolidated Foods. The Service based this ruling on its view that the payment of dividends from those subsidiaries to Douwe Egberts would have as one of its significant purposes a substantial reduction of income taxes (sec. 954 (b)(4)).

The committee believes that in this case, the long history of operation of the foreign business and the concerns of the Dutch tax authorities tend to indicate a lack of tax avoidance purpose. While not intending to disturb the Internal Revenue Service ruling position for past years, the committee believes that these factors warrant exclusion of certain dividends from foreign base company income in future years.

Explanation of Provisions

The bill will exempt from foreign base company income any dividend received by a controlled foreign corporation from a qualified foreign subsidiary (as defined below) if certain conditions are met. These conditions are: (1) the dividend is out of the earnings and profits accumulated by the qualified foreign subsidiary in taxable years beginning after December 31, 1982, and is attributable to the active conduct by the qualified foreign subsidiary of the business of buying, selling, and distributing coffee, (2) the country of incorporation of the controlled foreign corporation and the country where its principal offices are located do not impose tax on the receipt of such dividend, (3) the controlled foreign corporation was incorporated before 1962 and its principal activity is carrying on a trade or business that it carried on for many years before 1962 and that it has continuously carried on since 1962 and through the date of distribution, and (4) the taxpayer acquired control of the controlled foreign cor-

poration in 1978, but such control has been limited at all times after 1978 and before the date of distribution because more than one-half of the stock which it holds in the controlled foreign corporation is held as beneficiary of a voting trust in which the taxpayer's authority to appoint trustees is shared with the management of the controlled foreign corporation. The committee intends that the requirement that the controlled foreign corporation have carried on a trade or business for many years before 1962 be interpreted to require such activity for as great a period of time as Douwe Egberts carried on a trade or business before 1962. Dividends out of earnings and profits for any taxable year are to be treated as attributable to the active conduct of the business of buying, selling, and distributing coffee to the extent that such dividends do not exceed the earnings and profits attributable to that business for that year.

A qualified foreign subsidiary is a foreign corporation substantially all of the stock of which is owned by the controlled foreign corporation, and for which the taxpayer has elected the rule of exclusion that this bill provides. Controlled foreign corporation may elect this bill's rule of exclusion for only one foreign corporation. Such an election must be made by the U.S. taxpayer filing a statement with the Internal Revenue Service Center with which it files its return. The statement must contain the name, address and principal place of business of the controlled foreign corporation, and must clearly identify the foreign corporation dividends which will be excluded from being treated as foreign personal holding company income of the controlled foreign corporation. The election must be received by the Service Center by the sixtieth day after the date of enactment of this bill. Once made, the election is irrevocable.

Effective Date

The bill will apply to taxable years of foreign corporations beginning after December 31, 1982, and to taxable years of United States shareholders within which or with which such taxable years of such foreign corporations end.

III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

Budget Effects

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made about the effect on the budget of this bill, H.R. 3581, as amended. On the basis of projections supplied by Consolidated Foods Corporation, the committee estimates that the provisions contained in the bill, H.R. 3581, as amended, will reduce budget receipts by approximately $4 million annually beginning in fiscal year 1984. However, it is understood that the taxpayer would oppose an assertion by the Internal Revenue Service that the dividend distributions in question are in fact taxable. Consequently, there will be an effect on budget receipts only if the taxpayer's position is not sustained by the court.

The Treasury Department agrees with this statement.

Vote of the Committee

In compliance with clause 2(l)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 3581, as amended, was ordered favorably reported by voice vote.

IV. OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clauses 3(l)(3) and 2(l)(4) of Rule XI of the Rules of House of Representatives, the following statements are made with respect to the committee action on H.R. 3581, as amended.

Oversight Findings

With respect to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the committee advises that it was as a result of the committee's oversight activities with respect to the taxation of U.S. shareholders on the earnings of their controlled foreign corporations that the committee concluded that it is appropriate to enact the provisions contained in the bill.

On October 19, 1981, the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means held a hearing on H.R. 3581. On July 12, 1982, that Subcommittee, by a voice vote, ordered H.R. 3581 favorably reported to the full committee, with amendments. The Subcommittee transmitted a report to the full committee on September 10, 1982.

New Budget Authority and Tax Expenditures

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

Consultation with Congressional Budget Officials on Budget Estimates

With respect to subdivision (C) of clause 2(l)(3), the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated in part III of this report) and agrees with the committee's budget estimates.

Oversight by Committee on Government Operations

With respect to subdivision (D) of clause 2(l)(3), the committee advises that no oversight findings or recommendations have been submitted to the committee by the Committee on Government Operations regarding the subject matter of this bill.

Inflationary Impact

In compliance with clause 2(l)(4), the committee states that the enactment of this bill is not expected to have an inflationary impact on prices and costs in the operation of the national economy.

V. PROVISIONS OF EXISTING LAW REFERRED TO IN THE BILL AS REPORTED

For the information of the Members of the House of Representatives, the following provisions of existing law are referred to in the bill, as reported:

SEC. 954. FOREIGN BASE COMPANY INCOME.

(a) FOREIGN BASE COMPANY INCOME.—For purposes of section 952 (a) (2), the term "foreign base company income" means for any taxable year the sum of—

(1) the foreign personal holding company income for the taxable year (determined under subsection (c) and reduced as provided in subsection (b) (5)),

(2) the foreign base company sales income for the taxable year (determined under subsection (d) and reduced as provided in subsection (b) (5)),

(3) the foreign base company services income for the taxable year (determined under subsection (e) and reduced as provided in subsection (b) (5)), and

(4) the foreign base company shipping income for the taxable year (determined under subsection (f) and reduced as provided in subsection (b) (5)).

(b) EXCLUSIONS AND SPECIAL RULES.—

(1) [Repealed]

(2) EXCLUSION FOR REINVESTED SHIPPING INCOME.—For purposes of subsection (a), foreign base company income does not include foreign base company shipping income to the extent that the amount of such income does not exceed the increase for the taxable year in qualified investments in foreign base company shipping operations of the controlled foreign corporation (as determined under subsection (g)).

(3) SPECIAL RULE WHERE FOREIGN BASE COMPANY INCOME IS LESS THAN 10 PERCENT OR MORE THAN 70 PERCENT OF GROSS INCOME.—For purposes of subsection (a)—

(A) If the foreign base company income (determined without regard to paragraphs (2) and (5)) is less than 10 percent of gross income, no part of the gross income of the taxable year shall be treated as foreign base company income.

(B) If the foreign base company income (determined without regard to paragraphs (2) and (5)) exceeds 70 percent of gross income, the entire gross income of the taxable year shall, subject to the provisions of paragraphs (2), (4), and (5), be treated as foreign base company income.

(4) EXCEPTION FOR FOREIGN CORPORATIONS NOT AVAILED OF TO REDUCE TAXES.—For purposes of subsection (a), foreign base com-

pany income does not include any item of income received by a controlled foreign corporation if it is established to the satisfaction of the Secretary that neither—

(A) the creation or organization of such controlled foreign corporation under the laws of the foreign country in which it is incorporated (or, in the case of a controlled foreign corporation which is an acquired corporation, the acquisition of such corporation created or organized under the laws of the foreign country in which it is incorporated), nor

(B) the effecting of the transaction giving rise to such income through the controlled foreign corporation,

has as one of its significant purposes a substantial reduction of income, war profits, or excess profits or similar taxes.

(5) DEDUCTIONS TO BE TAKEN INTO ACCOUNT.—For purposes of subsection (a), the foreign personal holding company income, the foreign base company sales income, the foreign base company services income and the foreign base company shipping income shall be reduced, under regulations prescribed by the Secretary, so as to take into account deductions (including taxes) properly allocable to such income.

(6) SPECIAL RULES FOR FOREIGN BASE COMPANY SHIPPING INCOME.—Income of a corporation which is foreign base company shipping income under paragraph (4) of subsection (a) (determined without regard to the exclusion under paragraph (2) of this subsection)—

(A) shall not be considered foreign base company income of such corporation under any other paragraph of subsection (a) and

(B) if distributed through a chain of ownership described under section 958(a), shall not be included in foreign base company income of another controlled foreign corporation in such chain.

(7) SPECIAL EXCLUSION FOR FOREIGN BASE COMPANY SHIPPING INCOME.—Income of a corporation which is foreign base company shipping income under paragraph (4) of subsection (a) (determined without regard to the exclusion under paragraph (2) of this subsection) shall be excluded from foreign base company income if derived by a controlled foreign corporation from, or in connection with, the use (or hiring or leasing for use) of an aircraft or vessel in foreign commerce between two points within the foreign country in which such corporation is created or organized and such aircraft or vessel is registered.

(c) FOREIGN PERSONAL HOLDING COMPANY INCOME.—

(1) IN GENERAL.—For purposes of subsection (a)(1), the term "foreign personal holding company income" means the foreign personal holding company income (as defined in section 553), modified and adjusted as provided in paragraphs (2), (3), and (4).

(2) RENTS INCLUDED WITHOUT REGARD TO 50 PERCENT LIMITATION.—For purposes of paragraph (1), all rents shall be included in foreign personal holding company income without regard to whether or not such rents constitute 50 percent or more of gross income.

(3) CERTAIN INCOME DERIVED IN ACTIVE CONDUCT OF TRADE OR BUSINESS.—For purposes of paragraph (1), foreign personal holding company income does not include—

(A) rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person (within the meaning of subsection (d)(3).

(B) dividends, interest, and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing, or similar business, or derived from the investments made by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, and which are received from a person other than a related person (within the meaning of subsection (d)(3)), or

(C) dividends, interest, and gains from the sale or exchange of stock or securities received from a person other than a related person (within the meaning of subsection (d)(3)) derived from investments made by an insurance company of an amount of its assets equal to one-third of its premiums earned on insurance contracts (other than life insurance and annuity contracts) during the taxable year (as defined in section 832(b)(4)) which are not directly or indirectly attributable to the insurance or reinsurance of risks of persons who are related persons (within the meaning of subsection (d)(3)).

(4) CERTAIN INCOME RECEIVED FROM RELATED PERSONS.—For purposes of paragraph (1), foreign personal holding company income does not include—

(A) dividends and intent received from a related person which (i) is created or organized under the laws of the same foreign country under the laws of which the controlled foreign corporation is created or organized, and (ii) has a substantial part of its assets used in its trade or business located in such same foreign country;

(B) interest received in the conduct of a banking, financing, or similar business from a related person engaged in the conduct of a banking, financing, or similar business if the businesses of the recipient and the payor are predominantly with persons other than related persons; and

(C) rents, royalties, and similar amounts received from a related person for the use of, or the privilege of using, property within the country under the laws of which the controlled foreign corporation is created or organized.

(d) FOREIGN BASE COMPANY SALES INCOME.—

(1) IN GENERAL.—For purposes of subsection (a)(2), the term "foreign base company sales income" means income (whether in the form of profits, commissions, fees, or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or

the purchase of personal property from any person on behalf of a related person where—

(A) the property which is purchased (or in the case of property sold on behalf of a related person, the property which is sold) is manufactured, produced, grown, or extracted outside the country under the laws of which the controlled foreign corporation is created or organized, and

(B) the property is sold for use, consumption, or disposition outside such foreign country, or, in the case of property purchased on behalf of a related person, is purchased for use, consumption, or disposition outside such foreign country.

For purposes of this subsection, personal property does not include agricultural commodities which are not grown in the United States in commercially marketable quantities.

(2) CERTAIN BRANCH INCOME.—For purposes of determining foreign base company sales income in situations in which the carrying on of activities by a controlled foreign corporation through a branch or similar establishment outside the country of incorporation of the controlled foreign corporation has substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving such income, under regulations prescribed by the Secretary the income attributable to the carrying on of such activities of such branch or similar establishment shall be treated as income derived by a wholly owned subsidiary of the controlled foreign corporation and shall constitute foreign base company sales income of the controlled foreign corporation.

(3) RELATED PERSON DEFINED.—For purposes of this section, a person is a related person with respect to a controlled foreign corporation, if—

(A) such person is an individual, partnership, trust, or estate which controls the controlled foreign corporation;

(B) such person is a corporation which controls, or is controlled by, the controlled foreign corporation; or

(C) such person is a corporation which is controlled by the same person or persons which control the controlled foreign corporation.

For purposes of the preceding sentence, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to vote. For purposes of this paragraph, the rules for determining ownership of stock prescribed by section 958 shall apply.

(e) FOREIGN BASE COMPANY SERVICES INCOME.—For purposes of subsection (a)(3), the term "foreign base company services income" means income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which—

(1) are performed for or on behalf of any related person (within the meaning of subsection (d)(3)), and

(2) are performed outside the country under the laws of which the controlled foreign corporation is created or organized.

The preceding sentence shall not apply to income derived in connection with the performance of services which are directly related to the sale or exchange by the controlled foreign corporation of property manufactured, produced, grown, or extracted by it and which are performed prior to the time of the sale or exchange, or of services directly related to an offer or effort to sell or exchange such property.

(f) FOREIGN BASE COMPANY SHIPPING INCOME.—For purposes of subsection (a)(4), the term "foreign base company shipping income" means income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or from, or in connection with, the performance of services directly related to the use of any such aircraft, or vessel, or from the sale, exchange, or other disposition of any such aircraft or vessel. Such term includes, but is not limited to—

(1) dividends and interest received from a foreign corporation in respect of which taxes are deemed paid under section 902, and gain from the sale, exchange, or other disposition of stock or obligations of such a foreign corporation to the extent that such dividends, interest, and gains are attributable to foreign base company shipping income, and

(2) that portion of the distributive share of the income of a partnership attributable to foreign base company shipping income.

(g) INCREASE IN QUALIFIED INVESTMENTS IN FOREIGN BASE COMPANY SHIPPING OPERATIONS.—For purposes of subsection (b)(2), the increase for any taxable year in qualified investments in foreign base company shipping operations of any controlled foreign corporation is the amount by which—

(1) the qualified investments in foreign base company shipping operations (as defined in section 955(b)) of the controlled foreign corporation at the close of the taxable year, exceed

(2) the qualified investments in foreign base company shipping operations (as so defined) of the controlled foreign corporation at the close of the preceding taxable year.

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